United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-7049

UNITED STATES COURT OF APPEALS

For the Second Circuit

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ANITA B. BRODY,

Plaintiff-Appellant,

P/S

-against-

CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK and THE FIDELITY BANK,

Defendants-Appellees,

-and-

PENNSYLVANIA COMPANY,

Defendant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

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PRELIMINARY STATEMENT

The United States District Court for the Southern District of New York (Gagliardi, J.), on motion of defendants-appellees (hereinafter defendants), dismissed plaintiff's second amended complaint on the ground that she did not comply with the demand prerequisites of Federal Rule of Civil Procedure 23.1 in that her pleading did not relate to and support "an allegation of futility of making a demand on the board of directors of [the Pennsylvania Company] as constituted on the date of the filing of the second amended complaint." (Appx. 113a)

Additional grounds urged in support of dismissal were not passed upon by the District Court.

COUNTERSTATEMENT OF ISSUES PRESENTED

1. Where a preferred stockholder whose complaint was dismissed for failure to satisfy the requirements of Fed. R. Civ. P. 23.1, but was given leave anew to make a demand on the board of directors or plead facts excusing such demand, declines to make such demand, must the averments of futility of demand speak as of the date such stockholder chose not to make the demand?

2. Assuming plaintiff may properly plead her excuse as of the date of the filing of her original complaint, does

plaintiff's second amended complaint plead facts sufficient to excuse a demand on Pennco's board of directors in satisfaction of Rule 23.1?

3. Do defendants in a shareholders derivative suit (other than the corporation on whose behalf the suit was brought), have standing to raise plaintiff's failure to comply with Fed. R. Civ. P. 23.1?

COUNTERSTATEMENT OF FACTS

The Prior Amended Complaint

Plaintiff, a holder of nonvoting cumulative preferred stock of Pennsylvania Company (Pennco), commenced this action on June 14, 1971, against defendants and other banks* (the banks), both as a derivative action on behalf of Pennco and as a class action on behalf of herself and all other preferred shareholders of Pennco similarly situated.

The complaint, as amended on July 30, 1971, asserted derivative claims on behalf of Pennco under Section 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)) and common law, and a common law claim on behalf of plaintiff and other

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* The action was dismissed as to three bank defendants, Mellon National Bank & Trust Company, Pittsburgh National Bank and National Boulevard Bank of Chicago, for improper venue.

purported stockholders arising out of the same factual averments. (Appx. 6a-26a). Two counts, based upon alleged violations of the Interstate Commerce Act, were later discontinued.

Defendants' Prior Motion to Dismiss

The bank defendants moved to dismiss the amended complaint on the grounds, inter alia, that plaintiff had failed to make a demand on Pennco's directors before she commenced her derivative action, that no representative claim was stated and that no claim was stated under either the Federal securities laws or common law.

The district court (Gagliardi, J.) dismissed the derivative claims for failure to make a demand as required by Fed. R. Civ. P. 23.1, holding that the amended complaint's conclusory averments were insufficient to excuse plaintiff's failure to make a demand upon Pennco's directors, and that averments contained in affidavits and other papers filed by plaintiff failed to establish that a demand upon Pennco's sole common shareholder, the Penn Central Transportation Company's ("Railroad's") reorganization trustees, would be futile. The representative claims asserted on behalf of the preferred shareholders were also dismissed, on the ground that the purported claim was that of Pennco, not its

shareholders.*

On appeal to this Court, plaintiff raised two issues for the first time: (1) whether defendants have standing to raise plaintiff's failure to comply with Rule 23.1; and (2) whether under Delaware law and hence Rule 23.1, demand on Pennco's shareholders was required.

This Court, on July 3, 1973, unanimously affirmed the dismissal of the representative counts on the opinion of the district court. Brody v. Chemical Bank, 482 F.2d 1111 (2d Cir.), cert. denied, 414 U.S. 1104 (1973). It also affirmed the district court's determination that the averments of the amended complaint were insufficient to excuse plaintiff's failure to make a demand on Pennco's board:

> "Inasmuch as four trustees have been appointed for the bankrupt Railroad and since they in turn have selected a new board of four directors for Pennco, we cannot disagree with the court below that the allegations of the complaint are insufficient to excuse plaintiff's failure to make a demand on the Pennco board." 482 F.2d at 1114.

By so ruling, this Court rejected plaintiff's contention that only Pennco has standing to raise plaintiff's failure to comply with Rule 23.1. This Court agreed with plaintiff, however, that

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* Contrary to plaintiff's assertion in her brief (p. 6), she did not seek leave to replead before Judge Gagliardi, although she could have made such application at any time (Fed. R. Civ. P. 15(a). Plaintiff did, however, request discovery in connection with defendants' original motion to dismiss on the issue of her failure to make a demand on the directors of Pennco. She withdrew her request for discovery in her supplemental brief on defendants' motion to dismiss the second amended complaint.

under Delaware law, and hence under Rule 23.1, no demand on Pennco's shareholders was required.

Noting that plaintiff had sought to "establish that there was an interrelationship between the new Pennco board and the pre-bankruptcy management of the Railroad", the Court remanded, mandating:

> "The plaintiff then may either make a demand on the directors or not, as she chooses. In any event, the repleading must comply with Rule 23.1. See In Re Kauffman Mutual Fund, CCH Fed. Sec. L. Rep. ¶ 93,987, at 93,975 (1st Cir. May 14, 1973); 7A Wright & Miller, Federal Practice and Procedure: Civil § 1832, at 392 (1972)." 482 F.2d at 1114.

Plaintiff's petition to the United States Supreme Court for review of the dismissal of the representative counts was denied Brody v. Chemical Bank, 414 U.S. 1104 (1973).

Plaintiff chose to forego a demand upon Pennco's directors and filed a second amended complaint in January 1974.

The Second Amended Complaint

A. Plaintiff's Claims

The substantive averments of the two counts pleaded in the second amended complaint, repeating those made in plaintiff's two earlier pleadings, asserted Federal securities law and common law claims derivately on behalf of Pennco.

Count one, a claim under Section 17(a) of the

Securities Act of 1933 (15 U.S.C. § 77q(a)), averred that prior to the reorganization of Railroad, the bank defendants, knowing of Railroad's dire financial condition and unwilling to lend funds directly to Railroad, conspired with Railroad to cause Pennco to borrow $50,000,000 in return for Pennco's note or notes. Pennco was thereupon caused in May or June of 1970 to lend the funds so borrowed to Railroad in exchange for Railroad's note or notes which it is averred the banks knew or had reason to know were or would shortly become almost worthless. (Appx. 93a-100a).

Count two asserted a common law claim against defendants Chemical, Manufacturers, Irving, Chase and Montreal, and relied on diversity of citizenship jurisdiction. (Appx. 104a).

As in her two earlier complaints, plaintiff demanded judgment against the bank defendants (1) for rescission of the loan transactions, requiring defendants to look to Railroad and not to Pennco for repayment of the $50,000,000 loan, (2) for damages to Pennco, (3) for the profits and benefits gained by the bank defendants and Railroad and (4) for counsel and accounting fees. (Appx. 104a-05a).

B. Plaintiff's Averments Purportedly Excusing a Demand on Pennco's Board of Directors

With respect to her averments of the futility of making a demand on the directors of Pennco, plaintiff sought in her

second amended complaint to set forth reasons why prior to commencing this action in June 1971, a demand on the board of directors would have been futile.

Those averments are as follows:

(1) The directors of Pennco in office at the time of the commencement of this action were designated either by Railroad, by the trustees of Railroad, by officers of Railroad or by Pennco directors who had themselves been made such directors by Railroad (Second Amended Complaint ¶ 26(a)--Appx. 100a-01a);

(2) Plaintiff instituted a derivative action on behalf of Pennco in the Court of Common Pleas, Philadelphia County, against Railroad's parent holding company, and the old directors of Pennco, complaining of the "fraudulent funnelling of $50,000,000 by various banks through Pennco to Railroad". The directors of Pennco "decided actively to oppose plaintiff's effort to free Pennco from the $50,000,000 debt burden", filing preliminary objections in the Philadelphia action (Second Amended Complaint ¶ 26(b)--Appx. 101a) and had failed to take any affirmative action to challenge the loan transaction at issue in this case (Second Amended Complaint ¶ 26(c)--Appx. 101a-02a);

(3) The directors of Pennco at the time of the

commencement of this action had an interest in retaining their positions because of the emoluments of their offices (i.e., two directors received salaries for serving as directors of Pennco, a third director was receiving a salary for serving as an officer and director of Pennco and the fourth director was employed as President of Pennco under a contract pursuant to which a real estate investment and urban system counseling firm of which he was a principal owner received $200,000 a year from Pennco and $100,000 a year from a Pennco subsidiary) (Second Amended Complaint ¶ 26(d)--Appx. 102a); and

(4) The trustees of Railroad were seeking financing and thus would not wish to antagonize the bank defendants or the "financial community" by challenging the validity of the loan transaction (Second Amended Complaint ¶ 26(f)--Appx. 103a). The bank defendants, either by reason of Railroad's default on or as part of a settlement of a $300 million loan made by various financial institutions to Railroad, might become owners of a "substantial" amount of Pennco's common stock and thus would be in a position to exercise a "decisive" voice in the continued retention of the Pennco directors in their positions and their continued receipt of the financial

benefits they received from Pennco (Second Amended Complaint ¶¶ 26(e) and (g)--Appx. 102a-03a).

Defendants' Motion to Dismiss the Second Amended Complaint

The bank defendants moved to dismiss the second amended complaint on the ground that plaintiff had again failed to set forth facts sufficient to establish the futility of affording Pennco's directors the opportunity to exercise their corporate duties. Instead, plaintiff had merely culled from the materials she had previously submitted to this Court and the district court, some of the statements previously made in letters and affidavits. In numerous instances, however, her new averments contradicted her prior submissions.

The district court, in an opinion and order filed December 9, 1974, held that

> "in view of the fact that the Court of Appeals, in remanding expressly afforded the plaintiff another opportunity to make a demand, the allegations of paragraph 26 are misplaced. The facts pleaded by plaintiff to excuse demand should have related to and supported an allegation of futility of making a demand on the board of directors of Pennco as constituted on the date of the filing of the second amended complaint, January 9, 1974." (Appx. 112a-113a).

Nevertheless, the district court afforded plaintiff still another opportunity to "either make a demand on the directors or replead." (Appx. 113(a)).

Plaintiff, however, again chose to do neither, but rather filed a notice of appeal before her time to make a demand or replead had expired. (Appx. 114a-15a). After plaintiff's time had expired, the district court, on notice, entered judgment dismissing the action with prejudice. (Appx. 123a-24a). Plaintiff filed a notice of appeal from that judgment on February 28, 1975. (Appx. 125a).

Argument

POINT I

AFTER DISMISSAL OF A COMPLAINT FOR FAILURE TO COMPLY WITH RULE 23.1, WITH LEAVE TO EITHER MAKE A DEMAND OR REPLEAD, IF PLAINTIFF CHOOSES NOT TO MAKE A DEMAND HER EXCUSE FOR FAILURE TO DO SO MUST SPEAK AS OF THE DATE OF REPLEADING.

Federal Rule of Civil Procedure 23.1, "Derivative Actions by Shareholders", provides in pertinent part:

> "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . and the reasons for his failure to obtain the action or for not making the effort."

The purpose of this rule was summarized in In Re Kauffman Mutual Fund Actions, 479 F.2d 257, 263 (1st Cir.), cert. denied, 414 U.S. 857 (1973):

> "[I]t is normally the directors, not the stockholders, who conduct the affairs of the company. Hence, to be allowed, sua sponte, to place himself in charge without first affording the directors the opportunity to occupy their normal status, a stockholder must show that his case is exceptional. His initial burden is to demonstrate why the directors are incapable of doing their duty, or as the Court has put it, to show that 'the antagonism between the directory and the corporate interest . . . be unmistakable.'" (Emphasis added)

Before plaintiff could commence her action in 1971, she was first required to give the Board of Directors of Pennco the opportunity to make the corporate decision whether to sue. Failing that, plaintiff, in her complaint, was required to make a factual showing why the directors "are incapable of doing their duty". Both the district court and this Court have held that her showing was inadequate and for that reason she failed to state a claim. She was given another opportunity to satisfy the requirements of Rule 23.1.

At that point, in January 1974, plaintiff had no valid pleading but merely the right to file one. The policy behind Rule 23.1 was yet to be vindicated. Thus, a demand would first have to be made on the directors, or plaintiff would have to come forward with cogent reasons why no such demand was required. Manifestly it would be completely unavailing to make a demand on those individuals who were directors

in 1971 who were no longer in power in 1974. (See, e.g., Johnson v. Espey, 341 F. Supp. 764, 767 (S.D.N.Y. 1972). Such demand would vindicate nothing and would be irrelevant. Equally irrelevant at that point in time were reasons why a demand in 1971 would be futile, unless those reasons were of equal force in 1974. Only by giving the directors of Pennco in office in 1974 the right to exercise their corporate responsibilities, or, if valid reasons exist why this demand would be futile in 1974, to state those reasons, would the policy behind Rule 23.1 be satisfied.*

The status occupied by plaintiff in January 1974, was similar to that of a proposed intervenor in a derivative action which has been dismissed. In that situation, as here, no viable action is pending. Where a proposed intervenor seeks to enter an action in that posture, he must satisfy the requirements of Rule 23.1 as of the date of the proposed intervention and may not merely incorporate the prior demand or excuse of the original plaintiff. Abramson v. Pennwood Investment Corp., 392 F.2d 759, 761-62 (2d Cir. 1968);

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* As discussed infra, in connection with the allegations of the second amended complaint, facts before this Court or of which it may take judicial notice, demonstrate that many averments of the second amended complaint were known to plaintiff to be inaccurate and inapplicable to the situation which prevailed on the date she filed that pleading.

Pikor v. Cinerama Productions Corp., 25 F.R.D. 92, 95-96 (S.D.N.Y. 1960); Mullins v. De Soto Securities Co., 2 F.R.D. 502, 505 (W.D. La. 1942), appeal dismissed, 136 F.2d 55 (5th Cir. 1943); Bachrach v. General Inv. Corp., 29 F. Supp. 966, 968 (S.D.N.Y. 1939).*

Contrary to plaintiff's suggestion (Br. pp. 20-21), the requirement that her repleading excuse her failure to make a demand at the time of the filing of the second amended complaint in 1974 does not mean that every time new directors are elected to the board a new demand must be made. If plaintiff had properly commenced an action by complying with Rule 23.1 in 1971, the policy of permitting the corporation to control its own affairs would have been satisfied. Since plaintiff has thus far never complied with Rule 23.1, and her amended complaint has been dismissed on that ground, she was required in 1974 to confront the necessity of making a demand on the current board. For that reason, Nelson v. Pacific Southwest Airlines, 5 CCH Trade Reg. Rep. ¶ 60,124 (S.D. Cal. 1975), cited by plaintiff, is inapplicable to this case.

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* Nor is intervention the only occasion on which courts have relied upon the current futility of making a demand in evaluating compliance with Rule 23.1. In Landy v. Federal Deposit Insurance Corp., 486 F.2d 139, 152 (3d Cir. 1973), cert. denied 416 U.S. 960 (1974), the Court evaluated the facts in existence at the time it decided the appeal in determining that on remand, no "future demand" would be required to permit the suit to continue. Other courts have done so as well. E.g., Lynam v. Livingston, 257 F. Supp. 520, 524 (D. Del. 1966).

Finally, plaintiff's reliance on Fed. R. Civ. P. Rule 15(c), (Br. 22-23) is misplaced. The expression "relation back" in that Rule has a precise and well understood application, namely the tolling of the statute of limitations. See Advisory Committee Notes to 1966 Amendment to Rule 15(c), 39 F.R.D. 82-84. It does not permit a plaintiff, nor require a court, to ignore events occurring after the filing of a fatally defective complaint.

POINT II

EVEN IF PLAINTIFF MAY REPLEAD AS OF THE DATE OF HER ORIGINAL COMPLAINT, HER SECOND AMENDED COMPLAINT WAS PROPERLY DISMISSED BECAUSE IT DID NOT EXCUSE HER FAILURE TO MAKE A DEMAND UPON PENNCO'S BOARD OF DIRECTORS AS THEN CONSTITUTED.

In her original and first amended complaints, plaintiff sought to excuse her failure to make a demand upon Pennco's board by conclusory allegations of futility based on the power of Railroad, an alleged conspirator, to designate and control Pennco's directors.

Those allegations were rejected by the district court and this Court because they did not reflect the realities of Railroad's subsequent reorganization, the appointment of four trustees to oversee Railroad's affairs, and the appointment of an entirely new Pennco board of directors.

In stating that "the repleading must comply with Rule 23.1", this Court cited In re Kauffman Mutual Fund Actions, supra, 479 F.2d 257 (1st Cir.), cert. denied, 414 U.S. 857 (1973), a case which rejected conclusory pleading, and which demonstrated that averments excusing a demand will be given much more than the pro forma review urged by plaintiff:

> "We recognize the social desirability of bona fide, well founded minority suits. We also recognize the tremendous waste involved in suits that are not well founded. We do not accept the dictum in deHaas v. Empire Petroleum Co., 10 Cir., 1970, 435 F.2d 1223, at 1228, that '[c]ourts have generally been lenient in excusing demand' if it is to be applied to allegations as substantively deficient as the present. Such easy remarks overlook the requirement that the directors' 'antagonism . . . be unmistakable.' Delaware & Hudson Co. v. Albany R.R." 479 F.2d at 267.

In measuring whether a pleading complies with Rule 23.1, the court in Landy v. Federal Deposit Insurance Corp., 486 F.2d 139, 146 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974) stated:

> " . . . . the responsibility for determining whether or not a corporation shall enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management left to the discretion of the directors, United Copper Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-264, 37 S.Ct. 509, 61 L.Ed. 1119 (1917). Otherwise a litigious stockholder could easily intrude upon authority of those who are vested with responsibility for the operation of the corporation's business. Whether to forego an action or to bring suit for damages is a matter of business judgment. Such decision may involve not merely a consideration of legal principles but a balancing of business interests and relationships. . . ."

Although for purposes of a motion to dismiss, the well pleaded facts in the complaint must be accepted, the Court need not accept plaintiff's characterization of her

averments, but rather, as the Court did in In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), cert. denied, 414 U.S. 857 (1973), will disregard the conclusions and examine only those well pleaded factual averments to determine if they establish satisfactorily that a demand upon Pennco's board of directors would be futile. See, e.g., Hawes v. Oakland, 104 U.S. 450, 460-61 (1881); Landy v. Federal Deposit Insurance Corp., 486 F.2d 139, 147-50 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); Wachsman v. Tobacco Products Corp., 129 F.2d 815 (3d Cir. 1942); Guth v. Groves, 44 F. Supp. 851, 854 (S.D.N.Y. 1942).

One factor which sets this case apart from most cases excusing demand on the directors is that the directors of Pennco when the complaint was filed took no part in the alleged fraud and were not even in office at the time it allegedly was perpetrated. As this Court recognized,

> ". . . four trustees have been appointed for the bankrupt railroad and . . . they in turn have selected a new board of four directors for Pennco." 482 F.2d 1111, 1114 (emphasis added).

The board in office at the time this action was commenced were

> Alfred W. Martinelli, Senior Vice President and Administrative Officer, Pennsylvania Company;
>
> John H. McArthur, Associate Dean and Professor Harvard Graduate School of Business Administration;
>
> Victor H. Palmieri, President and Chief Executive Officer, Pennsylvania Company and Great Southwest Corporation, a principal subsidiary; and

> "George K. Whitney, Retired Managing Trustee, Massachusetts Investment Trust, Consultant to Massachusetts Financial Services, Inc., Honorary Chairman of the Board, Transportation Association of America." (Ostergard Affidavit, July 13, 1972, ¶ 2--Appx. 91a)

None of these directors were officers, directors or employees of Railroad when this lawsuit was commenced and, except for Mr. Martinelli, a former assistant vice-president-accounting of Railroad, none had been officers, directors or employees of Pennco or Railroad at the time of the alleged wrongful acts (Ostergard Affidavit, July 13, 1973, ¶ 3 Appx. 91a).

Well before this Court remanded this case to give plaintiff another opportunity to make a demand or replead, four additional directors were added to the Pennco board, none of whom had at any time been an officer, director or employee of Railroad -- Anthony M. Frank, President of the Citizens Savings and Loan Association, San Francisco, California; John F. Magee, President of Arthur D. Little, Inc.; Robert T. Sprouse, Professor of Accounting, Graduate School of Business Administration, Stanford University; and Robert G. Wiese, Managing Partner, Scudder, Stevens & Clark. (Ostergard Affidavit, July 13, 1972, ¶ 4--Appx. 91a-92a).

Significantly, plaintiff does not allege that any of the directors of Pennco, in office at the time this suit was originally brought, participated in any wrongdoing, acted in

collusion with any of the wrongdoers or were controlled by any of the wrongdoers.

In spite of these undisputed facts, plaintiff attempted to excuse her failure to make a demand on these directors with four purported excuses:

1. Designation of the new Pennco directors.

Plaintiff stated that the Pennco board in office at the date of the commencement of this action was designated either by Railroad, by the trustees of Railroad, by officers of Railroad or by Pennco directors who had themselves been made such directors by Railroad (second amended complaint ¶ 26(a)--Appx. 100a-01a). Such an averment fails to provide the basis for any inference that the directors will not perform their fiduciary duty to Pennco. Failure to make a demand can only be excused by an explicit and unequivocal factual showing of wrongdoing or bias. Director dishonesty or improper motive will not be presumed. As the New York Court of Appeals held in O'Connor v. Virginia Passenger & Power Co., 184 N.Y. 46, 53 (1906):

> "If the directors were the same as those who committed the wrongs, or if they were acting fraudulently, dishonestly or collusively with the [defendants] for the purpose of defrauding the corporation in the latter's interest, it was very easy to say so and there is no reason why the charge should not be explicitly and unequivocally made."

In short, there is nothing stated to suggest that

the alleged wrongdoers who formerly controlled Pennco and Railroad retained any influence over the Pennco directors in office when this action was commenced.

2. Pennco's position in the Philadelphia Court of Common Pleas.

Plaintiff charged that in July of 1970 she brought, in the Court of Common Pleas, Philadelphia County, a derivative action on behalf of Pennco against Railroad's parent company, Penn Central Company and the old directors of Pennco, attacking the "fraudulent funnelling of $50,000,000 by various banks through Pennco to Railroad". It is averred that the new directors of Pennco "decided actively to oppose plaintiff's effort to free Pennco from the $50,000,000 debt burden", filing preliminary objections in the Philadelphia action (second amended complaint ¶ 26(b)--Appx. 101a).

The second amended complaint was verified by plaintiff's counsel, Benedict Wolf pursuant to Fed. R. Civ. P. 23.1. (Appx. 106a) Mr. Wolf also submitted in this action on January 28, 1972, his affidavit, attaching as exhibits plaintiff's actual pleading and the response by Pennco in the Court of Common Pleas action. That affidavit and the exhibits thereto are a part of the record in this action (Appx. 28a et seq.). An examination of these exhibits on which the conclusory averments of the second amended complaint are presumably based reveals glaring conflicts seriously under-

mining the adequacy of the Wolf averments and the pleadings of futility.

Plaintiff's characterization of the Philadelphia complaint and Pennco's response repeated in her brief to this Court (Br. 8-9), simply does not survive examination of the actual Court of Common Pleas papers Mr. Wolf has placed in the record of this action. The complaint filed in the Philadelphia action (Ex. A to the Wolf Affidavit, January 28, 1972--Appx. 31a), alleged that Penn Central Company and the old Pennco directors had wrongfully caused Pennco to borrow from the Banks and reloan the proceeds to Railroad. No cause of action was asserted against the Banks. More significantly, no allegations of wrongdoing, no criticism of the bank defendants' conduct, was even raised.

The Preliminary Objections of Pennsylvania Company (Ex. B to the Wolf Affidavit, January 28, 1972---Appx 51a) did not go to the merits of the complaint, about which no opinion was expressed, but rather raised certain procedural objections and challenged plaintiff's standing as a holder of cumulative preferred stock to assert such claim on behalf of Pennco.

Even had the Pennco board in office when the Court of Common Pleas action was commenced, reached a decision as to the wisdom of bringing an action for $50,000,000 against a group of directors and a holding company whose principal asset was stock ownership of the insolvent Railroad, that decision

could in no way be held to interfere with the right of the board, several months later, to consider the advisability of a suit against the financially responsible lending banks. In Nussbacher v. Continental Illinois Bank & Trust Co. of Chicago, 61 F.R. D. 399 (N.D. Ill. 1973), plaintiff attempted to excuse her failure to make a demand on the basis that she had instituted an earlier identical action in which the directors refused to assist. The Court held this insufficient:

> "In the absence of formal demand that it enforce the right of the corporation, mere refusal of the board of directors to assist a shareholder in her first derivative suit--or even the board's opposition to said suit--is not an adequate excuse for failure to comply with the demand requirements of Fed.R.Civ.P. 23.1 in a subsequent separate suit to recover on the original cause of action. Accordingly, the above allegations are insufficient to excuse formal demand that the board of directors seek to recover on the cause of action alleged in the complaint." 61 F.R.D. at 404.

Given the actual content of the Philadelphia pleadings, moreover, it is specious to argue that any significance can be drawn from Pennco's failure to commence an action against the bank defendants up until the time plaintiff commenced her own action (second amended complaint ¶ 26(c)--Appx 101a-02a).* It is sheer bootstrap to contend that because the directors have not commenced an action, no

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* And, to the extent that plaintiff seeks to draw some inference from the fact that from the time she commenced this action until the date of her second-amended complaint, "the directors of Pennco are maintaining their adverse position to plaintiff's claim, and are still attempting to dismiss the Philadelphia Action" (Second amended complaint ¶ 26(b)--Appx 101a) (emphasis added), she is conceding the validity of Judge Gagliardi's holding that her excuse must speak as of that date.

demand need be made. If that were true, demand would never be required. It is precisely in the circumstances where a stockholder believes there exists a cause of action which the directors have not taken up, that a demand upon the directors is required.

> "When corporate action, or inaction, is subsequently challenged, [the directors'] duty is not extinguished, but, rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim,' Halprin v. Babbitt, 1 Cir., 1962, 303 F.2d 138, 141, it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response. Pomerantz v. Clark, 101 F. Supp. at 344. To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." In re Kauffman Mutual Fund Actions, 479 F.2d 257, 266-67, cert. denied, 414 U.S. 857 (1973).

3. Compensation of directors for serving as officers or directors of Pennco.

Plaintiff asserts that the directors of Pennco at the time of the commencement of this action had an interest in retaining their positions because of their emoluments of office. Allegedly, two of the directors received salaries for serving as directors of Pennco and a third director received a salary for service as both an officer and director of Pennco. The fourth director, it is averred, was employed as President of Pennco under a contract pursuant to which a counseling firm of which he is a principal owner received $200,000 a year from Pennco and $100,000 a year from a Pennco subsidiary. (Second

amended complaint ¶ 26(d)--Appx 102a.)

The fact that directors receive remuneration for performing duties as officers and directors of Pennco hardly creates an inference that those directors would breach their fiduciary duty to the corporation. Plaintiff does not allege that the directors do not perform valuable services for Pennco or that what they earn is not proper compensation for their responsibilities and a true reflection of their abilities. Indeed, Judge Fullam, in reviewing the merits of the proposed settlement of the $300 million loan made by various financial institutions directly to Railroad said of Pennco's management:

> "[t]he Trustees' efforts to obtain skillful management of Pennco have been extremely successful, with the result that the enterprise is now much improved. Pennco now involves very little effort on the part of the Trustees and their staff, and poses no substantial likelihood of cash drain." Re: Pennco Settlement Agreement, Corp. Reorg. Rep. Doc. No. 5540 at 4622 (E.D. Pa. April 16, 1973)

On August 31, 1973, in reviewing a proposed contract between the Trustee and Victor Palmieri, one of Pennco's directors, Judge Fullam emphasized the "demonstrated and undeniable expertise of Victor Palmieri himself". In Re Penn Central Transportation Co., 363 F. Supp. 906, 910 (E.D. Pa. 1973).

In sum, nothing is alleged that would establish that these men have or would betray their fiduciary duties

merely to remain in office. Significantly, even plaintiff shrinks from directly making such a charge.

Even more significantly, the alleged pressures that might potentially be brought to bear on the directors are themselves illusory, as set forth below.

4. The Railroad trustees' need for financing and the possibility that bank defendants might become owners of some of Pennco's common stock.

Plaintiff claims that a demand need not be made on Pennco's directors because the trustees of Railroad were seeking financing from financial institutions and therefore would not wish to antagonize the bank defendants or the "financial community" by challenging the validity of the Pennco loan (second amended complaint, ¶ 26(f)--Appx. 103a). This argument was previously urged on the motion to dismiss plaintiff's earlier complaint. Such a hypothesis, first advanced by plaintiff in March 1972 (Wolf Affidavit, March 15, 1972, ¶ 18--Appx. 83a), not only presumes the directors may be coerced into abandoning their fiduciary duties but that the court-appointed trustees of Railroad would contemplate removal of Pennco's directors in retaliation for their performance of that fiduciary duty. Finally, it presumes that "the financial community", thousands of independent financial

institutions, will consider making loans to Railroad on any basis other than the merits, and thus provide a motive for the trustees' improper conduct.

When it was first argued that Railroad's trustees would show improper hostility or exert an improper influence on Pennco, the district court responded:

> "In order to reach such a conclusion three facts must be assumed: first, that the court-appointed trustees have the power to control decisions of the Pennco Board; second, that the trustees will use this power to prevent the Pennco Board from commencing a direct suit to recover for the wrongs allegedly done to the corporation; and third, that in refusing to bring the suit the Pennco Board and the Trustees of the Railroad would be acting negligently or wrongfully and not as a result of a business judgment. There is no evidence before the Court upon which to base such assumptions." Brody v. Chemical Bank, Docket No. 71 Civ. 2639 at 9-10 (S.D.N.Y. July 26, 1972).

We submit that Judge Gagliardi properly evaluated these allegations. As such, plaintiff's assertion is no more than a vague possibility of a potential conflict of interest by the trustees of Railroad which in turn creates a hypothetical conflict of interest in Pennco's directors.

Claims of "conflict of interest" made against independently appointed individuals must be specific and convincing, and will be scrutinized with the utmost care. Landy v. Federal Deposit Insurance Corp., 486 F.2d 139, 148-50 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974). Plaintiff's untenable argument achieves no greater dignity or substance

by transposing statements from counsel's affidavit to a second amended complaint.

Plaintiff advances an alternative hypothesis to establish improper pressure on Pennco's directors. Plaintiff alleges that there is the "possibility" that the bank defendants might become owners of a "substantial" amount of Pennco common stock, either by reason of Railroad's default or as part of a settlement of a $300 million loan made by various financial institutions to Railroad against which Pennco's common stock was pledged. The bank defendants would allegedly then be in a position to exercise a "decisive" voice in the continued retention of the Pennco directors in their positions and at their present compensation (second amended complaint, ¶¶ 26(e) and (g)--Appx. 102a-03a).

The possibility is and has been tenuous at best, for it would first require the approval of the reorganization court and that court has, at least for the present, declined to approve the transfer of the stock to the financial group. (See Opinion of Fullam, J., Re: Pennco Settlement Agreement, Corp. Reorg. Rep. Doc. No. 5540 at 4622 (E.D. Pa. April 16, 1973).) That fact, of which the Court may take judicial notice, was also known to plaintiff when she filed her second amended complaint, since it was before this Court the last time this case was on appeal.

A far more serious flaw in plaintiff's allegation is contained in the assumption that the bank defendants would dominate Pennco should the stock be turned over to the financial institutions that made the $300 million loan.

Plaintiff's artfully phrased assertions that the bank defendants might become "substantial" stockholders with a "decisive vote" in Pennco's affairs attempt to achieve by conclusory language an illusion of potential domination not borne out by factual details already in the record of this case. When plaintiff first raised this argument (Wolf letter to Judge Gagliardi, July 11, 1972, p. 2--Appx. 86a), she had filed with the Court an affidavit providing the facts upon which the allegations were based (Wolf Affidavit, March 15, 1972, ¶ 18--Appx. 83a). That affidavit belies the verification of the second amended complaint. The bank defendants "decisive voice", in reality is apparently no more than plaintiff's artfu' gloss on her earlier assertion that four of the bank defendants were participants "to the extent of 20% of the $300 million loan and, therefore, participants in the collateral consisting of Railroad's Pennco stock." (Wolf Affidavit March 15, 1972, ¶ 18--Appx. 83a).

Plaintiff has not alleged any facts which would suggest that the financial institutions holding a decided majority of the common stock would permit a minority to coerce Pennco's directors to breach their fiduciary duty and deprive Pennco

and consequently the major shareholders of a substantial asset. This argument, as all the other of plaintiff's arguments, simply chooses to ignore any factor, even those previously asserted by her counsel, which undercuts her conclusion that demand on Pennco's directors would be futile.

The contention in plaintiff's memorandum that the loan transaction was not for a proper corporate purpose and thus demand on the directors is excused because the directors did not challenge it is equally without merit. The sentence fragment from In re Kaufman Mutual Fund Actions, 479 F.2d 257, 265 (1st Cir.), cert. denied, 414 U.S. 857 (1973), cited by plaintiff, is excised from a discussion of whether approval of an allegedly improper act at its inception by the directors is sufficient to excuse a subsequent demand prior to bringing suit. In this case none of the Pennco directors in office at the time this suit was brought was a director at the time of the transaction and consequently their failure to object is completely explicable. It is also not alleged that any of these directors benefited from the transaction in question.

Furthermore, plaintiff begs the question by asserting that there was no proper corporate purpose. If plaintiff conceded that the transaction was proper no cause

of action would exist. The question is, even if the propriety of the transaction were questionable, did plaintiff plead facts which show that the new directors will not make the decision whether or not to sue based upon the best interests of the corporation.

POINT III

THE BANK DEFENDANTS HAVE STANDING TO RAISE PLAINTIFF'S FAILURE TO COMPLY WITH RULE 23.1.

Plaintiff argues that the bank defendants have no standing to raise the question of plaintiff's failure to comply with Rule 23.1. She offers no authority for the proposition that a failure to comply with any of the Federal Rules of Civil Procedure may be raised by one defendant but not another.

But even as to Rule 23.1 and its predecessors, plaintiff's argument that equitable considerations have created limitations otherwise not present in the Federal Rules is unsupported by authority and is contrary to the practice of the courts.

Such a limitation was unrecognized in the earliest derivative action cases, those closest to the equitable roots of derivate action practice and most likely to have imposed a limitation. Thus in Hawes v. Oakland, 104 U.S. 450, 451-52 (1882), the failure to make a proper demand on the corporation's directors and shareholders was successfully raised by the defendant's demurrer, the corporation having failed to make any answer.

The modern cases have not questioned the real defendants' standing to raise the failure to make a demand, and have consistently examined the pleadings and dismissed

defective complaints on motion of the real defendants. See, e.g., Ash v. International Business Machines, Inc., 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966), aff'g, 236 F. Supp. 218 (E.D. Pa. 1964); Kaminsky v. Abrams, 281 F. Supp. 501, 503-504 (S.D.N.Y. 1968) (dictum); Norte & Co. v. Krock, 37 F.R.D. 543 (D. Mass. 1965); Levitan v. Stout, 97 F. Supp. 105, 114-16 (W.D. Ky. 1951); Kohler v. McClellan, 77 F. Supp. 308, 314-15 (E.D. La. 1948), aff'd sub nom. Kohler v. Humphrey, 174 F.2d 946 (5th Cir. 1949).

The statement in Ripley v. International Railways of Central America, 8 App. Div.2d 310 (1st Dep't 1959) relied on by plaintiff as support for her contention that defendant banks lack standing to assert plaintiff's failure to comply with Fed. R. Civ. P. 23.1 is dictum on the face of the opinion since the Court went on to hold that "there was sufficient evidence to warrant an inference both of demand and futility of demand". 8 App. Div.2d at 317. More significantly, the Court of Appeals affirmed on other grounds. 8 N.Y.2d 430 (1960).*

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* Koral v. Savory, Inc., 276 N.Y. 215 (1937) relied upon by plaintiff, could not be more remote from the issue presented. In that case, the shareholder suing derivatively made a demand on the court appointed receiver, who refused to bring suit. The shareholder alleged in his derivative action that such refusal was based on improper influence over the receiver by the wrongdoers. The Court of Appeals held that although it was true, as the wrongdoers claimed, that the Court could remove the receiver and appoint a new one, this did not preclude the Court from also permitting the derivative suit to continue. It was in that connection that the Court stated

> "[t]he alleged wrongdoers may not dictate how the choice should be exercised." 276 N.Y. at 221, 11 N.E.2d at 886.

To the extent that New York law may be consulted on the issue of standing, the only case which we have found in which the problem was before the New York Court of Appeals is Marco v. Sachs, 269 App. Div. 845 (2d Dep't), aff'd, 295 N.Y. 642 (1945). In that case not only was the successful motion to dismiss for failure to make a demand upon directors raised by the real defendants, but the corporation on whose behalf the action had been brought appealed the dismissal and filed a brief in the New York Court of Appeals arguing that it approved of the litigation and urging that the failure to make a demand upon its directors should be overlooked. The Court of Appeals nevertheless affirmed the dismissal of the complaint.

Certainly the neutrality of Pennco on this motion neither cures plaintiff's failure to make a prior demand nor estops the bank defendants from raising plaintiff's failure to comply with Rule 23.1.

In any event, plaintiff raised this issue in this Court with respect to her first amended complaint.*

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* Plaintiff nevertheless states in her brief that she is unaware of any case where

> "the plaintiff challenge[d] the right of any defendant other than the corporation to use this defense or assert that the right to insist on prior demand belongs only to the corporation on whose behalf the action was brought." (Br. 24)

This Court held that "the allegations of the complaint are insufficient to excuse plaintiff's failure to make a demand on the Pennco board" (482 F.2d 1111, 1114), implicitly upholding the bank defendants' standing to raise this objection. Under the doctrine of the "law of the case", plaintiff should not be permitted to raise the same issue of law once decided against her by this Court. 1B Moore, Federal Practice § 0.404[10].

Conclusion

For the reasons stated, the judgment should be affirmed.

April 21, 1975

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April 21, 1975.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ANITA B. BRODY, Appellant, -against- CHEMICAL BANK, Appellees.	Docket No. 75-7049 AFFIDAVIT OF SERVICE BY MAIL

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

The undersigned, being duly sworn, deposes and says: Deponent is over the age of 18 years, is not a party to this action and resides at 710 Rhinelander Ave., Bronx, N.Y. 10462

On the 21st day of April 19 75 deponent served the annexed Brief

upon (~~such of~~) the below listed attorney(s) by depositing ~~a~~ two true ~~copy~~ (copies) of the same securely enclosed in a postpaid, properly addressed wrapper in an official depository under the exclusive care and custody of the United States Postal Service within the State of New York.

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Sworn to before me this 21st)
day of April 19 75)

Ralph M. Dionne

RALPH M. DIONNE
Notary Public, State of New York
No. 41-6042070
Qualified in Queens County
Cert. Filed in New York County
Commission Expires March 30, 1976

John Murphy

John Murphy